FILE COPY

FIL
FEB 7
CHARLES ELMO

IN THE

Supreme Court of the United States,

OCTOBER TERM—1932.

Nos. 476, 477, 478.

D. B. HEINER, Collector of Internal Revenue for the 23rd District of Pennsylvania,
Petitioner,

vs.

DIAMOND ALKALI COMPANY, a corporation,
Respondent.

C. G. LEWELLYN, formerly Collector of Internal Revenue for the 23rd District of Pennsylvania,
Petitioner,

vs.

DIAMOND ALKALI COMPANY, a corporation,
Respondent.

BRIEF FOR DIAMOND ALKALI COMPANY.

JOHN W. DAVIS,
Attorney for Respondent,
15 Broad Street,
New York, N. Y.

Of Counsel:

WILLIAM A. SEIFERT,
MAYNARD TEALL,
Union Trust Building,
Pittsburgh, Pa.

MARION N. FISHER,
15 Broad Street,
New York, N. Y.

THE BALLOU PRESS NEW YORK

INDEX.

PAGE

Opinions of the Courts Below 1
Statement of the Case 2
Question Presented 4
Statutes Involved 4
Summary of Argument 4
Argument 6

I. The action of the courts below was confined to matters of law and fact. No discretionary act of the Commissioner was either reviewed or set aside 6

Federal income and profits taxes must be determined upon the true net income 8
The extent of the Commissioner's discretionary powers under Sections 327 and 328 8

II. The courts below could not do otherwise than apply to corrected net income the ratios determined by the Commissioner; and this was not prejudicial to the Government, for it gave the taxpayer a smaller judgment than it would have obtained under any other rates than could have been used 12

Petitioners' arguments discussed 14

Conclusion 21

Appendix "A" 22
Appendix "B" 25

Authorities Cited.

Decisions.

PAGE

Brown's "Shamrock" Linens, Ltd. v. Bowers, 48 Fed. (2nd) 103 9–10

Chicago Frog & Switch Co. v. United States, 67 Ct. Cls. 662 9–10

Cleveland Automobile Co. v. United States (Feb. 24, 1932) 18

Commissioner v. Ohio Falls Dye & Finishing Works, 50 Fed. (2nd) 660 19

Cramer & King v. Commissioner, 41 Fed. (2nd) 24 9

Duquesne Steel Foundry Co. v. Commissioner, 41 Fed. (2nd) 995 9

Edwards v. Cuba Railroad Co., 268 U. S. 628 13

Eisner v. Macomber, 252 U. S. 189 13

Enameled Metals Co. v. Commissioner, 42 Fed. (2nd) 213 9

Kekaha Sugar Co. v. Burnet, 50 Fed. (2nd) 322 9

Miles v. Safe Deposit & Trust Co., 259 U. S. 247 13

Norton Co. v. Commissioner, 50 Fed. (2nd) 664 19

Railway Supply Co. v. Burnet, 51 Fed. (2nd) 437 9

Standard Rice Co. v. Commissioner, 41 Fed. (2nd) 481.. 9

United States v. Henry Prentiss & Co., Inc., (Jan. 9, 1933) 11

United States v. Supplee Biddle Hardware Co., 265 U. S. 189 13

Williamsport Wire Rope Co. v. United States, 277 U. S. 551 9–12

Article 901, Regulations 45 20

Statutes Involved.

Revenue Act of 1918, Section 301 (a) and (b)..... 22

Revenue Act of 1918, Section 327..... 23

Revenue Act of 1918, Section 328 (a) and (b)..... 23

IN THE

Supreme Court of the United States,

OCTOBER TERM—1932.

Nos. 476, 477 and 478.

D. B. HEINER, Collector of Internal Revenue for the 23rd District of Pennsylvania,

Petitioner,

against

DIAMOND ALKALI COMPANY, a corporation,

Respondent,

C. G. LEWELLYN, formerly Collector of Internal Revenue for the 23rd District of Pennsylvania,

Petitioner,

against

DIAMOND ALKALI COMPANY, a corporation,

Respondent,

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR DIAMOND ALKALI COMPANY

Opinions of the Courts Below.

The opinions of the Circuit Court of Appeals for the Third Circuit, both on the original and the rehearing, are reported

in 60 Fed. (2nd) 505. The findings of fact and conclusions of law of the District Court in Nos. 476 and 477 relating to the year 1918 (R. 81) are reported in 39 Fed. (2nd) 645, but the findings and opinion in No. 478, relating to the year 1919 (R. 27), are not reported.

Statement of the Case.

The 1918 and 1919 income and profits tax returns of respondent were filed in due course. Respondent applied for computation of its profits taxes under Sections 327 and 328. Owing to an abnormality of capital (R. 55, Nos. 476, 477) the Commissioner determined that the profits taxes computed under Section 301 would work a hardship upon the respondent because such taxes would be grossly disproportionate to the taxes computed by reference to the representative corporations as provided by Section 328. He therefore computed the profits taxes by determining that ratio of respondent's net income for each year as the average profits tax of representative corporations bore to their net average income. The ratios so determined by the Commissioner were 54.54% for 1918 and 18.31% for 1919.

Following the filing of the returns, examinations and audits were made by the Commissioner and large additional taxes were from time to time proposed (R. 60, 69, 70, 75, Nos. 476 and 477), and sundry protests were filed and conferences held (R. 70). Respondent's claims with respect to the various deductions, particularly amortization of war facilities and depreciation, were not allowed and the Commissioner's final determination of net income was $3,821,143.63 for 1918 and $2,708,248.07 for 1919. Using the ratios as determined by him under Section 328 he arrived at profits taxes of $2,084,324.26 for 1918 and $495,871.87 for 1919.

The taxes were paid, claims for refund filed, such claims rejected, and suit brought to recover back the additional taxes paid. In the claims for refund and the suits as filed the respondent contended that the profits tax rates employed by the Commissioner did not satisfy the statute because the taxpayer was not compared with representative corporations and that net income as computed by the Commissioner was greatly in excess of the true net income because he did not allow adequate deductions on account of depreciation and amortization of war facilities.

By agreement of counsel the point as to selection of comparatives and determination of profits tax rates was presented and argued prior to the trial. The trial court held, adversely to the respondent and in favor of the petitioners, that it had no authority to review the administrative action of the Commissioner in selecting the comparatives to be used. Thereafter trial was had and the District Court found errors in the income as determined by the Commissioner, correcting it downward. Both parties appealed and the Circuit Court of Appeals further corrected the income downward. The case comes before this court with the correct income for 1918 standing at $3,291,410.30 instead of $3,821,143.63 as found by the Commissioner, and for 1919 at $2,603,676.64 instead of $2,708,248.07 as found by the Commissioner. Neither the District Court nor the Circuit Court of Appeals, in its second decision, disturbed the comparatives used by the Commissioner in arriving at the tax ratios found by him. The courts below merely applied the rates found by the Commissioner to the income as corrected by them. Both parties accept the income as now judicially determined to be the correct income.

The petitioners contend that since special assessment was applied for and granted the excess profits taxes as computed by the Commissioner must remain unchanged notwithstanding the fact that such taxes were the result of applying the unreviewable rates to incorrect income.

This state of facts and the issue drawn presents the following question.

Question Presented.

Whether the fact that the Commissioner determined the profits tax rates under Section 328 deprives the courts of power to correct mistakes in the amount of such taxes caused by admitted error in the Commissioner's determination of the amount of net income to which he applied his rates.

Statutes Involved.

The statutes involved are Sections 301(a), 327 and 328 of the Revenue Act of 1918 (c. 18, 40 Stat. 1058, 1088, 1093), which are printed in Appendix A, *infra*, pp. 22-24).

Summary of Argument.

I.

The Federal profits tax rates or ratios, however determined, must be applied to the correct net income. Where the income determined by the Commissioner is incorrect it must follow that the profits tax determined by him is incorrect.

The discretionary acts confided to the Commissioner by Sections 327(d) and 328 of the Revenue Act of 1918 do not

include an unreviewable determination of net income by him. When the court below judicially determined the true net income of respondent for 1918 and 1919 and applied the unreviewable rates or ratios determined by the Commissioner under Section 328 it neither reviewed nor set aside any discretionary act of the Commissioner. Its action was confined to matters of law and fact. Neither the decision of this court in *Williamsport Wire Rope Co.* v. *United States, infra,* nor any of the decisions denying review by the courts of the Commissioner's discretionary acts under Sections 327 and 328 have held to the contrary.

II.

Since it is self evident that the profits taxes must be based upon correct income and the Commissioner's ratios or rates determined under Section 328 are not reviewable, the court below was required to apply such ratios to the net income determined by it.

The Government suggests that if the Commissioner had determined net income at the same figures as the court determined it he might have used different comparatives and therefore different rates. "Might" does not mean "would". If the net income corrections were sufficiently substantial to have caused the Commissioner to use different comparatives and different rates the burden was upon the Government to prove it. The presumption is that the comparatives and the rates used by the Commissioner were correct.

Even assuming the use of different comparatives and different rates the result would be profits taxes lower than those found by the court. The profits tax (whether computed by rates taken directly from Section 301 or by the

average of rates of representative corporations whose profits tax rates were taken directly from Section 301) is computed from graduated rates. That is, when income increases the rates increase and when income decreases the rates decrease, and there is no such thing as a higher rate for a reduced income in any given case. If, therefore, it be assumed for the same of argument that different comparatives and different rates would have been used, in view of the lower incomes, such rates would have been lower than the rates that the Commissioner determined and the courts below applied. Hence the judgment is not prejudicial to the Government.

Petitioners' arguments all lead to the proposition that wherever the profits tax rate is determined under Section 328 errors of income that have been made by the Commissioner and the consequent errors in profits tax may not be corrected judicially. That proposition is unsound and unjust.

ARGUMENT.

I.

The action of the courts below was confined to matters of law and fact. No discretionary act of the Commissioner was either reviewed or set aside.

At the outset it should be pointed out that petitioners' statement of the question involved and their arguments are premised upon assumptions that are essentially erroneous. It is asserted that the court below set aside the special

assessment[1] made by the Commissioner and made a special assessment[1] of its own. This statement is not correct. It assumes everything to be argued in this case.

Section 328, under which the tax in special assessment cases is computed, provides in subsection (a) that the tax "shall be the amount which bears the same *ratio* to the *net income* of the taxpayer * * * as the average tax of representative corporations * * * bears to their average net income * * *", and in subsection (b) provides, "* * * the *ratios* between the average tax and the average net income * * * shall be determined by the Commissioner * * *". The essence of the statute is an average "*ratio*" derived from representative corporations to be applied to the net income which necessarily means the correct net income. It is a mere play upon words to say that the elements of discretion go to determining the tax. The inescapable fact is that the entire discretionary action of the Commissioner, namely, selection of representative corporations with all the elements entering into such selection, is confined to arriving at the *ratio*.

The court below did not review or set aside any discretionary act of the Commissioner, for it did not make any determination regarding abnormality, gross disproportion, or the selection of representative corporations. On the contrary, it only decided whether or not the taxpayer was entitled to certain additional deductions claimed by it and thus arrived at the correct net income, a function which the courts perform in practically every tax case presented to them. The court then applied to this correct net income the ratios which were determined by administrative action and which it had no authority to reject or change.

---

[1] The term "special assessment" is not found in the statute but is a convenient though inexact term used to cover the steps taken under Sections 327 and 328.

To say that the court set aside any discretionary administrative action or performed any discretionary actions which are administrative is to ignore the facts of what happened below. There is no administrative discretion in the determination of net income for that is wholly a matter of law and arithmetic.

Federal Income and Profits Taxes Must Be Determined Upon the True Net Income.

It is a self-evident proposition that the income or profits taxes imposed by the revenue statutes are a percentage, rate, or ratio of the *true* net income of the taxpayer determined in accordance with the statutory definitions of gross income and deductions. Whatever the rates may be, and however they may be determined under the statute, they are to be applied to such true income and not to incorrect income. If the rates, whether they be stated in Section 230 (income tax rates) or in Sections 301, 302 and 328 (profits tax rates), are applied to incorrect income the result is incorrect taxes. If the income is judicially corrected, it must follow that a correction in the taxes results automatically.

The Extent of the Commissioner's Discretionary Powers Under Sections 327 and 328.

Under Section 327 the Commissioner must compute the ratio or rate from representative corporations:

(a) If he is unable to determine the invested capital as provided by the statute (see subdivision (a));

(b) In the case of all foreign corporations (see subdivision (b));

(c) Where the property paid in for stock was a mixed aggregate of tangibles and intangibles and the necessary segregations cannot be made (see subdivision (c));

> (d) Where on application by the taxpayer he finds that there is an abnormality of capital or income and the effect of such abnormality is to produce a tax which, when computed in the ordinary way, is grossly disproportionate to the tax when computed under Section 328 (see subdivision (d)).

The Commissioner acts in a discretionary capacity only under subdivision (d) where he alone is empowered to decide whether or not an abnormality exists and if so whether or not a gross disproportion in tax exists.[2] When he has made this decision he then must turn to Section 328 and find the ratio there described just as he must do in the cases under (a), (b) and (c).

Under Section 328 only the Commissioner can select "representative corporations whose invested capital can be satisfactorily determined * * * and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted, and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances". When he has made his selection it cannot be disturbed, in the absence of an abuse of his discretionary powers.[3]

There is nothing in either of these sections of the statute which says, as petitioners contend, that once he determines

---

[2] *Williamsport Wire Rope Co.* v. *United States*, 277 U. S. 551, *supra*; *Duquesne Steel Foundry Co.* v. *Commissioner*, 41 Fed. (2nd) 995 (C. C. A. 3rd), affirmed *per curiam*, 283 U. S. 299; *Enameled Metals Co.* v. *Commissioner*, 42 Fed. (2nd) 213 (C. C. A. 3rd), affirmed *per curiam*, 283 U. S. 799; *Standard Rice Co.* v. *Commissioner*, 41 Fed. (2nd) 481 (C. C. A. 5th); *Cramer & King* v. *Commissioner*, 41 Fed. (2nd) 24 (C. C. A. 3rd); *Kekaha Sugar Co.* v. *Burnet*, 50 Fed. (2nd) 322 (Ct. App. D. C.); *Railway Supply Co.* v. *Burnet*, 51 Fed. (2nd) 437 (Ct. App. D. C.).

[3] *Brown's "Shamrock" Linens, Ltd.* v. *Bowers*, 48 Fed. (2nd) 103 (C. C. A. 2nd), cert. denied 283 U. S. 865; *Chicago Frog & Switch Co.* v. *United States*, 67 Ct. Cls. 662.

a net income no court can change it for the purpose of computing a profits tax or that once he computes a tax on the net income as determined by him no court can change that tax through the medium of changing income.[4] All of the decisions by the courts involving Sections 327 and 328 have been confined to whether the courts could *require* the Commissioner to allow special assessment under Section 327(d) (See authorities, footnote (2), page 9, *ante*); or whether the *rates* determined by the Commissioner under Section 328 through comparison with representative corporations could be judicially reviewed. (See authorities, footnote (3), p. 9, *ante*.)

In connection with the action taken by the Commissioner under Section 328, that is, the propriety of rates found by him from representative corporations, only two cases have gone to the courts. They indicate quite clearly that the discretionary action lies in the finding of the ratios or rates. In *Brown's "Shamrock" Linens, Ltd.* v. *Bowers, supra,* the Circuit Court of Appeals for the Second Circuit, in describing the question presented, said:

> "Thus it is apparent that the complaint attacks the correctness of the *ratio* used by the Commissioner and asks the court to review all the comparative data which under the statute must enter into his determination of such *ratio*." (Italics ours.)

In *Chicago Frog & Switch Co.* v. *United States*, 67 Ct. Cls. 662, the taxpayer complained of the selection of comparatives and the court's description of the taxpayer's contention is:

---

[4] *Tax* equals *rate* times *income*. The rate, whether determined under Section 328 or found in the statute elsewhere, cannot be changed by any court. But the income may validly be corrected and the result must be a correction of the tax. If either of two factors is corrected a correction in their product follows.

> "* * * that said profits tax was not the amount which bore the same *ratio* to the net income of plaintiff * * * as the average tax of representative corporations * * * bore to their average net income * * *." (Italics ours.)

In *United States* v. *Henry Prentiss & Co., Inc.*, decided this term, the Supreme Court had occasion to consider Sections 327 and 328 in connection with a question different from that here involved. But the court characterized Section 328 in the following language:

> "Section 328 provides in effect that in cases covered thereby the tax shall be computed without reference to the value of the invested capital and shall be determined by the *ratio which the average tax of representative corporations engaged in a like or similar trade or business bears to their average net income.*" (Italics ours.)

Thus it is apparent that the Commissioner does not turn to representative corporations and select a profits tax from them. He selects the average ratio or rate from them and with such rate computes the profits tax by applying it to the net income.

The law, as pronounced in the cases just cited (p. 9, *ante*), is precisely the same law that the trial court applied in this case. In the pleadings the taxpayer objected to the comparatives that the Commissioner had used. The Government answered that such comparatives were not subject to judicial review. The point was argued, by agreement, in advance of trial and the trial court decided adversely to the taxpayer. The substance of the trial court's preliminary decision was reiterated in its final decision in the following language (R. 101, Nos. 476, 477):

> "The plaintiff, in addition to the amortization and depreciation claims in respect to the 1918 taxes, has sought a review of the commissioner's determination of its ex-

cess-profits tax rate for 1918. We feel that this court does not have jurisdiction to review the commissioner's ruling in this respect. See *Williamsport Wire Rope Co.* v. *United States,* 277 U. S. 551."

In correcting the net income for each year and applying the unreviewable rates to such income the court below neither reviewed nor set aside the Commissioner's discretionary acts. Its correction of the income was a matter of law and fact and its computation of the tax a mere matter of multiplication.

II.

The courts below could not do otherwise than apply to corrected net income the ratios determined by the Commissioner; and this was not prejudicial to the Government, for it gave the taxpayer a smaller judgment than it would have obtained under any other rates that could have been used.

The rates determined by the Commissioner are not reviewable. It is self-evident that profits taxes must be computed upon the true income. The result is that reached by the court below.

In an effort to avoid this legally correct and just result petitioners have resorted to sundry arguments, the sum and substance of which are that, if the Commissioner has determined a ratio under Section 328, the profits taxes which result from applying such ratio to an incorrect income may not be recovered. In other words, that under such circumstances no court can correct errors of net income however grievous. Carried to its ultimate conclusion petitioners'

argument means that the Commissioner may collect profits taxes in excess of the true net income or collect such taxes when there is no net income whatsoever. Such results could transpire without any abuse of discretion by the Commissioner for he might in perfectly good faith disallow a large deduction or include an item which constitutionally is not income[5] and proceed to compute the tax under Section 328 by fairly selecting comparative corporations on the basis of the net income determined by him. A court might, upon review, allow the deduction in question or strike out the disputed item from income, but be powerless to order a refund of any part of the erroneous profits tax.

If this court should reverse the judgment and deny recovery of any part of the profits taxes found by the Commissioner the result would be to approve a profits tax of $2,084,324.26 on a true net income of $3,291,410.30, or a profits tax rate of 63.33% instead of 54.54% for 1918. Similar action for 1919 would produce a profits tax rate of 19.10% instead of 18.31%. That action would be a real review and reversal of the Commissioner's discretionary action taken under Section 328 for it would set aside the rates which he found to be proper and substitute therefor higher rates—notwithstanding lower income.

The arguments resorted to by the petitioners in an effort to accomplish the foregoing results will not bear examination.

---

[5] Practically every tax case that goes to the courts involves the propriety of deductions or income items. That the Commissioner has at various times sought to tax that which constitutionally is not income is well illustrated by a number of cases that have come to this court. (*Eisner* v. *Macomber*, 252 U. S. 189; *Miles* v. *Safe Deposit & Trust Co.*, 259 U. S. 247; *U. S.* v. *Supplee Biddle Hardware Co.*, 265 U. S. 189; *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628.)

Petitioners' Arguments Discussed.

Petitioners argue that if the court corrects the net income it cannot correct the profits tax without resorting to Section 301. This is a contradiction of all the other arguments because it implies that the court must reject the unreviewable rates adopted by the Commissioner and ignore the Commissioner's determination that there was an abnormality and gross disproportion which under the statute *requires* computation of the ratio under Section 328. Such action would clearly be a denial, and therefore a judicial review, of the Commissioner's discretionary action.

Their chief argument is that if the income is corrected the comparatives used by the Commissioner *may* no longer be representative within the meaning of Section 328 and that if the Commissioner were to make another selection he *might* choose comparatives which would show rates so much higher than 54.54% and 18.31% that the profits tax based upon the correct net income would be at least as high as that previously computed upon the incorrect net income. And further, they say, this might remove the gross disproportion mentioned in Section 327(d).

It is not said, even by way of argument, that the comparatives *would certainly* or *probably* cease to be appropriate for the corrected net income or that the Commissioner *would certainly* or *probably* select different comparatives if given the opportunity. As the court below well said:

> "It is a bare possibility that the reduction of the income to the proper and just amount might have some conceivable effect on the selection of representative corporations."

When this case was tried petitioners successfully objected to any evidence regarding the accuracy of rates under any con-

ditions. The accuracy of these rates became the law of this case. The courts are not required, and it is submitted are not at liberty, to speculate or surmise as to things that might or might not happen. Their function is to consider the record as they find it together with matters of which they may take judicial notice. Such bare possibilities do not justify a reversal of the judgment in this case.

The argument that correction of net income *might* move the Commissioner to use different comparatives and different rates is mere speculation. It is equally true that the corrections might *not* be sufficiently substantial to move the Commissioner to make any change at all. Courts are interested in facts rather than mere possibilities. If in truth the income corrections would have the effect which the Government asserts they *might* have, the burden was on the Government to prove it by evidence. For in the absence of evidence the presumption is that the Commissioner's comparatives and rates were correct.

Granting the possibility that a change in income might have some effect on the selection of representative corporations, it is quite apparent that if new comparatives were selected on account of the correction of income to a smaller amount the average ratio of tax to net income could under no circumstances be higher than the ratios found by the Commissioner; on the contrary such new ratios would be lower.

As already demonstrated it is fundamental that the profits tax bears a relation to net income, so much so that if the income is increased the *rate* increases; and if the income is decreased the *rate* decreases. Thus, with changes in income, the resulting tax changes are in a geometric proportion rather than in a mere arithmetic proportion. Therefore,

when the income is corrected downward there is a compelling conclusion that the tax must be reduced. Now if the Commissioner were to select new comparatives on account of the reduction of the taxpayer's income he would find that the reduction of income has not changed the capital employed[6] in the business and the gross income has not been changed. (The court changed net income by allowing deductions, leaving gross income undisturbed). He would then find a smaller net income which would mean smaller "profits per unit of business transacted" and smaller "amount and rate of war profits or excess profits." Therefore, his new comparatives should be similar to his old comparatives with respect to capital and gross income but should show lower net income, profits per unit of business, and excess or war profits. The average ratio of new comparatives with unchanged capital and gross income, but reduced net income (with attendant reductions in the other statutory elements) would inevitably be lower than 54.54% and 18.31%.

To support their assertion that this *might* not be true petitioners employ an illustration, set forth in Appendix "C" of their brief, showing a theoretical computation by special assessment before income is reduced and another theoretical computation with new comparatives after income is reduced. The fallacy of their illustrations lies in the fact

---

[6] Section 328 provides that in selecting comparatives consideration is to be given to "capital employed". Obviously in abnormal cases this phrase does not mean statutory invested capital under Section 326 because such capital is not to be used under Section 328. The capital actually employed in business in an abnormal case includes capital assets that are valuable but which may not be included in "invested capital". That is an abnormal case, and when comparatives are selected the Commissioner is not to turn to those having a statutory invested capital similar to that of the taxpayer but to those having a statutory invested capital similar to the "capital employed" in the taxpayer's business.

that the average invested capital of the new comparatives is only 40% as great as the average invested capital of their old comparatives. In no other way could petitioners, by any computation made under the statute, show higher rates for a reduced income. In Appendix "B", page 24, *infra*, petitioners' illustrations are discussed and other illustrations are given which show that if new comparatives are used with the same or approximately the same capital but income reduced to the same extent that the taxpayer's income is reduced the result is profit tax rates *lower* than those determined for the incorrect, greater income.

Petitioners argue that if income is changed the use of new comparatives might result in no disproportion. In the first place, if no disproportion exists between the taxes recomputed under Section 301 and the taxes resulting from the use of the rates found by the Commissioner the Government is not harmed because as long as it receives the correct amount of profits tax the manner of computation becomes wholly immaterial. In any event, in the case at bar, the difference between the profits taxes under the court's judgment and as recomputed by the Bureau of Internal Revenue under Section 301 and set forth in their brief is great, being more than $100,000 for 1918 and more than $220,000 for 1919[7].

---

[7]

	Section 301	*Court's Judgment*	*Difference*
1918	$2,197,633.50	$1,795,307.70	$402,325.80
1919	699,665.10	476,724.84	222,940.26

It would hardly require administrative discretion to say that the above differences constitute gross disproportions and a real hardship. Now if there could be a new selection of comparatives the average ratios would be lower, because of the reduced income, with the result that the above differences would be even greater.

Under no theory of this case can it be said that the judgment below establishes a profits tax that is improper because too low; on the contrary, the conclusion that a recomputation under Section 328 based upon the corrected net income should result in profits taxes even lower than those found by the court is irresistible. We concede the court had no power, however, to give judgment for any less profits taxes than it has done. But certainly the fact that the relief given is probably inadequate and legally cannot be made adequate is not justification for reversing the judgment and denying all relief.

Petitioners have cited the decision of the District Court for the Northern District of Ohio in *Cleveland Automobile Co.* v. *United States,* decided February 24, 1932. The court decided that the income as determined by the Commissioner was correct; therefore, everything it said with respect to the power of the courts to correct the profits tax if the income is corrected was dictum and unnecessary to the decision in the case. This decision is referred to and discussed at greater length at page 7 of our brief in opposition to petition for certiorari.

Another argument which petitioners urge is that this taxpayer applied for special assessment and when it was granted by the Commissioner the taxpayer was compelled to accept the result. In this connection petitioners point to the letter of December 23, 1925 (R. 75, Nos. 476, 477) in which the Assistant to the Commissioner said:

> "Before consideration can be given your application for special relief there must be a final determination of your tax liability computed on the basis of statutory invested capital."

The letter also provided that a protest might be filed and it is suggested that such may not have been done by the respondent. On page 17 of petitioner's brief appears the statement that it is customary to request acquiescence by a taxpayer in the amount of income and invested capital, "as was done in this case". The only authority for that statement is the language quoted above from the letter dated December 23, 1925. In point of fact the income tentatively determined by the Commissioner in that letter was changed in the letters of March 19, 1927, and July 11, 1927, which specifically refer to respondent's protests and oral conferences (R. 60, 70, Nos. 476, 477). This assertion of fact is unjustified.

The final determination of net income which quite clearly must be made before any tax can be computed by the Commissioner is his determination, and may be right or wrong. Invariably he makes his determination in every tax case regardless of the manner in which the tax may be computed. The statute imposes that duty upon him, but no taxpayer is required to accept his determination as final. [8]

The regulations contain no provision that a taxpayer applying for special assessment must agree with the Commis-

---

[8] It would appear that in some special assessment cases the taxpayer and the Commissioner in fact formally agreed upon the net income before computation of the profits tax by special assessment. Compare *Commissioner* v. *Ohio Falls Dye & Finishing Works*, 50 Fed. (2nd) 660; *Norton Co.* v. *Commissioner*, 50 Fed. (2nd) 664. But there is nothing to indicate that any such agreement existed in the case at bar. In fact the entire history of the controversy conclusively refutes any such idea. The chief basis of this litigation was the act of the Commissioner in reducing the amortization allowance from $1,344,000, as determined by the Amortization Section in 1921, to the relatively small sum of $387,000 (R. 3, Nos. 476, 477), and the disallowance of depreciation taken in the returns and charged off on the taxpayer's books by the sum of $439,000 (R. 3, Nos. 476, 477). These large deductions were never acceptable to the taxpayer and were never agreed to by it.

sioner's determination. As a matter of fact in the majority of cases the application for special assessment was made at the time the return was filed,[9] as this taxpayer did for the year 1918 (Ex. LL, B. E. Vol. II, p. 635). It was customary also to entertain and allow applications for special assessment made after returns were filed, as was done in this case for the year 1919.

Once an application for special assessment has been filed and the Commissioner finds an abnormality and disproportion he must then compute the tax under Section 328. It is hardly conceivable that these *relief provisions* were designed as traps into which taxpayers might step and find themselves beyond hope of any judicial review of income and deductions that the Commissioner may determine. Such an argument, if applicable in a case of this kind, would likewise apply to all other special assessment cases where the taxpayers had no option but must have their taxes computed under Section 328 (see p. 8, *ante*).

When Congress enacted these sections of the law it did so with a report of the Senate Finance Committee before it to the effect that no part of Title III of the statute was more important; that the computation of profits taxes in the ordinary way would work great hardship in exceptional cases; and that the statutory method placed a heavy penalty on conservative financing and a premium on over-capitalization.

The report concludes with the following words:

> "Indeed without such classification the constitutionality of the whole tax might, because of its unequal

[9] Article 901, Regulations 45, provides that "a corporation which comes within the provisions of subdivision (d) of Section 327 may make application for assessment under the provisions of Section 328, which application shall be attached to its return in the form of a statement setting forth in full" certain information and data which is here unimportant.

operation, be open to serious question." (Senate Report No. 617, 65th Congress, Third Session, p. 14.)

Such language contradicts any thought that a taxpayer obtaining special assessment could be required to bargain away all right to judicial review of income and deductions.

CONCLUSION.

Petitioners' arguments all lead to the proposition that wherever a ratio of profits tax has been determined by the Commissioner under Section 328 the Commissioner's errors of income with the consequent errors in profits tax may not be corrected judicially.

It is respectfully submitted that such proposition is unsound legally as well as unjust, and that the decision of the court below applying the unreviewable rates to the correct net income should be affirmed.

JOHN W. DAVIS,
Attorney for Respondent,
15 Broad Street,
New York, N. Y.

Of Counsel:

WILLIAM A. SEIFERT,
MAYNARD TEALL,
Union Trust Building,
Pittsburgh, Pa.

MARION N. FISHER,
15 Broad Street,
New York, N. Y.

APPENDIX "A".

Section 301(a) and (b), Section 327, and Section 328(a) and (b) of the Revenue Act of 1918 are as follows:

"SEC. 301. (a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this Act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

FIRST BRACKET.

"30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET.

"65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

THIRD BRACKET.

"The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets.

"(b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:

FIRST BRACKET.

"20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET.

"40 per centum of the amount of the net income in excess of 20 per centum of the invested capital."

"SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

"(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

"(b) In the case of a foreign corporation;

"(c) Where a mixed aggregate of tangible property and intangible property has been paid for in stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

"(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax is determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply in any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive."

"SEC. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the *same ratio* to the *net income* of the taxpayer (in excess of the

specific exemption of $3,000 for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

"In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determine under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

"(b) For the purposes of subdivision (a) the *ratios* between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

"In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 per centum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 per centum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 per centum of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 per centum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 per centum per month on such excess from the time the installment was due."

APPENDIX "B".

Petitioners have argued that if the Commissioner were to select new comparatives to meet the condition of corrected income he *might* select comparatives as illustrated in Appendix "C" attached to their brief (p. 41). That illustration assumes a taxpayer's income and statutory invested capital (not "capital employed" in the business) as found by the Commissioner and then assumes comparatives with average invested capital of $300,000 and average net income of $100,000, the same as that of the taxpayer. The rate or ratio of profits tax resulting is 53.6%. Then follows a recomputation with new comparatives. The new comparatives show an average invested capital of only $120,000 with the result that there is a tax of $54,400, that is, a ratio of tax to income of 65.5%.

The fallacy of the illustration lies in the fact that the new comparatives have invested capital of only 40% of the previous comparatives, notwithstanding the fact that the taxpayer's capital employed in its business cannot possibly have been changed by reason of a correction downward of its income.

What the Commissioner should undoubtedly do if he were to select new comparatives would be to use representative corporations having substantially the same invested capital as the invested capital of that previously used but having smaller incomes. If this were done he would have the following:

New Comparatives with the same invested capital.

Average invested capital	$300,000
Average income	83,000
Average profits tax under Section 301 ..	40,000
Ratio of profits tax to income	48.31%

(Compare this with the rate of 53.6% established by the previous comparatives.)

Suppose the Commissioner in selecting new comparatives should seek an invested capital which is as much lower than that of the prior comparatives as the corrected income is lower than that of the income as determined by him, and this should certainly be the limit to which he might go. We would then have the following:

Average invested capital	$250,000
Average income	83,000
Average profits tax under Section 301 ..	44,000
Ratio of profits tax to income	53.01%

Here again the rate is below that previously established by special assessment, namely, 53.6%, and far below the 65.5% in petitioner's second computation by special assessment.

In his illustration, therefore, the Commissioner could not by new comparatives establish a rate as high as that previously found by special assessment except through the obviously incorrect expedient of reducing average invested capital to a greater extent than income is reduced. If in the case at bar he should select new comparatives under Section 328 after correction of the income by the court he could not establish rates as high as 54.54% and 18.31% without doing the same thing.